

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Mail Processing Network
Rationalization Service Changes, 2012

Docket No. N2012-1

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS (PR-T-1)
TO UNITED STATES POSTAL SERVICE INTERROGATORIES
(USPS/PR-T1-2 THROUGH 8)

(June 5, 2012)

Attached to this cover page are the responses of the Public Representative witness Neels (PR-T-1) to the Interrogatories of the United States Postal Service (USPS/PR-T1-2 through 8) filed May 22, 2012.

Interrogatory USPS/PR-T1-1 seeks material subject to the work product doctrine, and the Public Representative objected to such production on May 31, 2012.

Each interrogatory is stated verbatim and followed by the response.

Respectfully Submitted,

/s/ Christopher J. Laver

Public Representative for
Docket No. N2012-1

901 New York Ave, N.W. STE 200
Washington, DC 20268-0001
(202) 789-6889; Fax (202) 789-6891
christopher.laver@prc.gov

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

USPS/PR-T1-2. On page 3, lines 20-22, you characterize the Postal Service position as entailing an argument “that the size of the network and the number of processing facilities it operates is [*sic*] driven by the requirements for handling of First-Class Mail at its current standards of service,” thereby implying that you do not agree with the Postal Service. Please explain the extent of your agreement or disagreement and provide the complete foundation for your position.

RESPONSE:

I did not intend to imply agreement or disagreement with the Postal Service. Rather, I was merely stating what I understood the position of the Postal Service to be.

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

USPS/PR-T1-3. On page 4 (beginning on line 4) you further characterize your understanding of the Postal Service position:

The Postal Service has argued that a relaxation of services standards for First-Class Mail will allow it to consolidate mail processing into a smaller set of facilities, and in the process, permit it to shed significant costs, expanding utilization of the machinery

Please explain the extent of your agreement or disagreement with this characterization of the Postal Service position and provide the complete foundation for your position.

RESPONSE

I do not disagree with this statement. My understanding of the proposed changes, their relationship to the requested relaxation in service standards, and the cost savings the Postal Service expects to realize as a result are based upon the description of the proposed changes presented in the testimony of David E. Williams (USPS-T-1). While I have not conducted a thorough analysis of them, I find Mr. Williams' arguments to be plausible, given my understanding of Postal Service operations and transportation networks.

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

USPS/PR-T1-4. Please refer to the section of your testimony identified as “B. Market Dominant Services” commencing on page 6 of your testimony. In the last paragraph of that section you state “the Postal Regulatory Commission has followed well-established regulatory procedures that have been implemented and over time refined in a number of other network industries.”

- a. Please identify each of the network industries you have in mind.
- b. For each of the industries identified in response to part (a), please identify and describe each such industry’s initial regulatory implementation.
- c. For each of the industries identified in response to part (a) or whose regulatory implementation you characterize in response to part (b), please also identify and describe the refinements over time to which you refer.

RESPONSE

- a) Other industries I am aware of in which price cap regulations have been employed include telecommunications, water distribution, pipelines and toll roads.
- b) All of the industries listed in my response to part (a) are global in scope. Regulatory practice can vary substantially from country to country. While I have previously encountered price caps like those implemented by the Postal Regulatory Commission, I do not know when such caps were first implemented in the industries listed in part (a), or in which country the implementation occurred. Some of the earliest price cap regulatory regimes I am aware of were implemented in the United Kingdom in the energy and telecommunications industries.
- c) Once again, the global nature of the industries in question and the diversity of regulatory regimes in operation around the world make it impossible to provide a comprehensive response. With that caveat, the refinements to which I was referring include the switch from limitations of rates of change of individual rates to revenue caps or constraints on weighted average prices that provide the regulated entity with more freedom to alter individual prices within the constraint of a global cap; addition of bonus or penalty provisions for improvements in or

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

(Response to USPS/PR-T1-4 continued) reductions in service quality; and implementation of provisions for sharing gains or losses if the returns earned by the regulated entity fall above or below specified threshold values.

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

USPS/PR-T1-5. In section IV of your testimony, “The Economic Rationale for Price Cap Regulation” commencing on page 8, please confirm that you identify two “incentive problems” arising under price cap regulation, including “limited incentives to reduce cost” and to “invest capital inefficiently.” If you do not confirm, please explain why and clarify what you mean by incentive problems.

- a. Please provide your complete understanding of how the Postal Service has (i) attempted to and (ii) succeeded (or not) in reducing its cost structure since the PAEA took effect in late 2006.
- b. Please provide your complete understanding of what capital investments the Postal Service has made since early 2007 and any return on investment each created.
- c. Focusing just on the last two years, please provide your complete understanding of what capital investments the Postal Service has made and their current status.
- d. Please confirm that your testimony characterizes the two “incentive problems” as the “Averch-Johnson effect” which recognizes that (i) “if a firm is being compensated in proportion to its capital” then (ii) “it has an incentive to increase its use of capital ... beyond an efficient level” (iii) thereby “increas[ing] the magnitude of the profit it is allowed to earn.” Please explain completely any failure to confirm and correct the attempted characterization in section (d).
 - i. What is your understanding of whether the Postal Service is, or is not, being compensated in proportion to its capital? Please explain how you arrive at your understanding.
 - ii. What is your understanding of the extent to which the Postal Service has, or has not, increased its use of capital both since passage of Public Law 109-435 and in the past few years? Please explain how you arrive at your understanding. If you understand that the Postal Service has increased its use of capital, is your further understanding that it has done so beyond an efficient level? Please provide a full explanation for any affirmative response to this last compound question.
 - iii. Please provide your complete understanding of 1) the profits the Postal Service has earned in each year since Public Law 109435 took effect, 2) whether such profits have gone “beyond an efficient level,” and if so, 3) when that occurred and how you can tell.

RESPONSE

I do not confirm. This interrogatory appears to be premised upon a misunderstanding of my testimony. I believe that the incentive effects cited in the interrogatory arise not

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

(Response to USPS/PR-T1-5 continued) under price cap regulation, but rather under traditional cost based regulation. They arise, I believe, because of the tendency under cost-based regulation for increases in cost to translate directly into increases in revenue. If the regulated entity possesses sufficient market power, increases in allowed operating costs will simply be passed along to consumers. Increases in allowed capital expenditures will increase the total return that the regulated entity is permitted to earn.

- a) I do not have detailed information regarding the Postal Service's efforts to reduce its cost structure. My understanding of its cost structure is derived from general press accounts in which the Postal Service appears to have explored the possibility of closing low volume post offices, eliminating Saturday delivery and reducing staff through buyouts and early retirements.
- b) I do not have information on the capital investments that the Postal Service has made since 2007, or of the return associated with any such investments.
- c) N/A. Please see my response to subpart b.
- d) I do not dispute that characterization of the Averch-Johnson effect.
 - i.) I do not believe the Postal is being compensated in proportion to its capital. I understand that the Postal service sets prices subject to a price floor for competitive services (specifically, a requirement that the revenues generated by these services should cover their attributable costs, plus a specified fraction of institutional costs), a price cap for market dominant services, and what customers are willing to pay for both sets of services. Taken as a whole, in recent years, the revenues generated by the Postal Service's market dominant services have failed to cover their attributable costs.
 - ii.) See my responses to subparts b. and c. above.
 - iii.) I have not monitored the profitability since the passage of Public Law 109-435, and do not have a detailed understanding of what profits it may have earned over that period. I do understand that in recent years the Postal Service has incurred significant operating losses. As a general matter, I do not believe it is efficient for an organization to incur significant operating losses on an ongoing basis.

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

USPS/PR-T1-6. What is your understanding of the extent to which the Postal Regulatory Commission “monitor[s] and evaluate(s) the spending and investment decisions” of the Postal Service? (Page 9, last paragraph.)

RESPONSE:

It is my understanding that the Postal Regulatory Commission issues reports, such as the Annual Compliance Determination, that review the Postal Service’s finances, including incurred costs and revenues. In the process of such review the Commission reviews changes in costing methodology that stem from investment decisions. The scope of oversight, however, is not limited to that provided the Postal Regulatory Commission. The Postal Service, to my understanding, is also regulated by its Board of Governors, who have a more direct role in evaluating spending and investment decisions.

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

USPS/PR-T1-7. Please confirm that in section V of your testimony (“The Relationship Between Price and Quality”) you make the point that changes over time for price and quality should be considered together, rather than in isolation from one another. Please explain completely any failure to confirm and state, in a single sentence, your point.

- a. Please confirm that service quality for First-Class Mail single-piece volume has improved as measured by modern service standards since Public Law 109-435 became law (reference Postal Service Annual Reports and/or PRC Annual Compliance Reports if necessary). Please explain completely any failure to confirm.
- b. Please confirm that single-piece First-Class Mail is a major component of First-Class Mail. Please explain completely any failure to confirm.
- c. Please assume that performance against current service standards for delivery of single-piece First-Class Mail has improved over the past five years. How, if at all, do you understand that such service quality improvement is 1) reflected in, 2) accommodated by, or 3) accounted for in the current price cap regimen applicable to market dominant products? Please explain the complete foundation for your understanding.
- d. Please confirm that modern service standards for First-Class Mail measure success or failure to effect delivery within the time (number of days) specified by the applicable service standard. Please explain completely any failure to confirm.
- e. Please confirm that, as a hypothetical matter, service standards could be defined in terms of absolute, or piece-specific, speed of delivery from entry to delivery. If you confirm, please provide at least one example of how this could be undertaken.
- f. Please confirm that under current service standards for First-Class Mail, what is reported is the percentage of mail pieces subject to a particular standard (i.e., two days, or three days) actually delivered within the specified timer [*sic*] period. If helpful, please explain your response. Please explain completely any failure to confirm.

RESPONSE:

- a) Confirmed.
- b) Confirmed
- c) To the extent that performance against current service standards for delivery of single-piece First-Class mail has met standards, this would imply that the Postal

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

(Response to USPS/PR-T1-7 continued) Service has complied with the requirements of the price cap regimen established by the PRC for this product. To the extent that performance against current service standards for delivery of single-piece First-Class mail has not met standards, this would imply that the Postal Service has not complied with the requirements of the price cap regimen established by the PRC for this product.

- d) Confirmed.
- e) It is not clear how the service standard articulated in this subpart differs from that articulated in subpart d. I am thus unsure how to respond.
- f) Confirmed.

RESPONSES OF PUBLIC REPRESENTATIVE WITNESS NEELS TO
UNITED STATES POSTAL SERVICE INTERROGATORIES

USPS/PR-T1-8. In section VI of your testimony (Price Caps and Quality Concerns), please confirm that you describe two possible regulatory approaches that can address tradeoffs associating price with quality, the latter of which “requires ... a great deal of information about customer preferences.”

- a. Please confirm that the Postal Service conducted market research in which it sought via both qualitative and quantitative means to assess customer reaction to network rationalization (see testimonies of witnesses Elmore-Yalch (USPS-T-11) and Whiteman (USPS-T-12)).
- b. Please confirm that witness Whiteman (USPS-T-12 at 15) reports, based in part upon qualitative market research, that “Mailers expect First-Class Mail™ to be delivered within a reasonable period of time and be reliable; absolute speed is less important.” Please explain completely any failure to confirm.

RESPONSE:

- a) Confirmed. It is my understanding the Postal Service also conducted quantitative market research with the same aim earlier in the process and did not complete the research. See USPS-LR-N2012-1/70.
- b) Witness Whiteman’s testimony speaks for itself.